

**BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA**

Order Instituting Rulemaking on the  
Commission's Own Motion to Assess and Revise  
the New Regulatory Framework for Pacific Bell  
and Verizon California Incorporated.

Rulemaking 01-09-001  
(Filed September 6, 2001)

Order Instituting Investigation on the  
Commission's Own Motion to Assess and Revise  
the New Regulatory Framework for Pacific Bell  
and Verizon California Incorporated.

Investigation 01-09-002  
(Filed September 6, 2001)

**ASSIGNED COMMISSIONER'S RULING  
REVISING THE SCHEDULE FOR PHASE 2**

This ruling revises the schedule for Phase 2 in order to allow a more timely resolution of certain issues raised in the audit report that was prepared by Overland Consulting (Overland) and submitted by the Telecommunications Division (TD). The issues -- namely findings by the auditors that Pacific Bell (Pacific) significantly overstated its costs for pensions, post-retirement benefits other than pensions (PBOPs), depreciation, and income taxes -- have a potentially large impact on Pacific's reported earnings and, hence, sharable earnings that would be returned to ratepayers. In light of the potentially large effect of these pending issues and the uncertainty they create for ratepayers and Pacific, it is appropriate to accelerate the resolution of these issues.

## Background

In Phase 2 of this proceeding the Commission will consider factual issues associated with (1) the audit of Pacific Bell, and (2) how service quality has fared under the New Regulatory Framework (NRF). The current schedule for Phase 2 is as follows:

| <b>Phase 2 Schedule</b>                                     |   |
|---|---|
| <b>Event</b>  | <b>Date</b>   |
| Pacific and Verizon File Service Quality Compliance Reports | January 15, 2002  |
| TD Files Pacific Audit Report                               | February 22, 2002   |
| Pacific Files Response to TD's Audit Report                 | April 15, 2002  |
| Parties Submit Surveys on Service Quality                   | April 15, 2002  |
| Written Testimony   | Opening Testimony: May 15, 2002<br>Reply Testimony: June 7, 2002      |
| Motions to Strike   | Motions to Strike: June 28, 2002<br>Replies to Motions: July 12, 2002 |
| Evidentiary Hearings  | July 22 – August 2, 2002  |
| Briefs re: Phase 2 Issues                                   | Opening Briefs: August 16, 2002<br>Reply Briefs: August 30, 2002      |
| Draft Decision re: Phase 2                                  | October 2002  |

On February 21, 2002, TD submitted the audit report prepared by Overland. The report alleges, among other things, that Pacific underreported its regulated operating income by \$1.94 billion during 1997, 1998, and 1999. The report states that the bulk of the underreported income was due to incorrect costs

that Pacific reported for pensions, PBOPs, depreciation, and income taxes. The report concludes that, had Pacific correctly reported its operating income, Pacific's customers would have received a refund of \$349 million under the NRF earnings sharing mechanism that was in effect during 1997 and 1998; and that customers would have received an additional refund of \$457 million if the earnings sharing mechanism had been in effect during 1999. The report also alleges that Pacific repeatedly hindered and delayed TD's audit.

Pacific submitted its response to the audit report on April 15, 2002. In general, Pacific denies that it underreported its income or impeded the audit.

## **Discussion**

The current schedule for Phase 2 was established without the benefit of Overland's audit report. Now that the report is in hand, it is advisable to revise the schedule for Phase 2. In particular, the audit report recommends major audit adjustments that, if adopted, would result in a significant refund for Pacific's customers. It is in the public interest to resolve these issues quickly so that any refund that may be owed to Pacific's customers may be paid as soon as possible. Conversely, if the proposed audit adjustments are not adopted, then Pacific will benefit from an earlier determination that no refund is required based on those proposed adjustments.

The \$1.94 billion of underreported earnings identified in the audit report is comprised of dozens of separate items. Addressing all of these items will likely require a considerable amount of time and effort, as will the Phase 2 issues pertaining to service quality. However, the great bulk of the underreported earnings is concentrated in just four areas - pensions, PBOPs, depreciation, and income taxes. These four areas can likely be addressed in a fraction of the time that will probably be required for all Phase 2 issues combined.

The resolution of the four issues in the audit report that have the largest potential financial impact on customers can be accelerated if they are resolved before other Phase 2 issues. Accordingly, this ruling bifurcates the schedule for Phase 2. In Phase 2A, the Commission will consider whether Pacific has misreported its costs for the following items:

| <b>Type of Cost</b>   | <b>Amount of Alleged Misreported Cost</b> | <b>Relevant Portions of the Overland Audit Report</b>   |
|---|---|---|
| 1. Pensions   | \$357 million <sup>1</sup>                | All of Chapter 7 except for those issues addressed in Sections VI, VII, and VIII.   |
| 2. PBOPs  | \$528 million <sup>1</sup>                |   |
| 3. Deprecation Reserve Deficiency   | \$612 million <sup>1</sup>                | All of Chapter 8 except for those issues addressed in Sections III.C, III.D, and III.E.   |
| 4. Income Tax Normalization Issues associated with (i) Items 1-3 above, and (ii) the Universal Service Fund | \$411 million <sup>2</sup>                | All of Chapter 9 except for those issues that are (i) addressed in Sections IV through VII, and (ii) associated with any item in Table 9-5 other than pensions, PBOPs, and depreciation reserve deficiency. |

1. The amount of the cost shown in table does not include income tax effects, which would reduce the amount of the cost shown in the table.

2. Amount consists of the following items from Table 9-5 of the Overland audit report: \$167,589,000 (pensions) + \$39,878,000 (SFAS 106) + \$203,618,000 (Universal Service Fund). Amount does not reflect other possible effects of tax normalization issues that might be associated with Items 1-3 in the above table. These other possible effects are within the scope of Phase 2A.

Phase 2A will also address (1) whether the previously identified issues lead to sharable earnings, and (2) allegations that Pacific impeded the audit to the extent the allegations are raised in those parts of Chapters 7, 8, and 9 of the

Overland audit report that address the previously identified issues. In Phase 2B, the Commission will address all other Phase 2 issues.<sup>1</sup>

The schedules for Phases 2A and 2B adopted by this rulings are as follows:

| <b>Phase 2A Schedule</b>              |   |
|---------------------------------------|---|
| <b>Event</b>                          | <b>Date</b>   |
| Written Testimony for Phase 2A Issues | Opening Testimony: May 8, 2002<br>Reply Testimony: May 17, 2002     |
| Motions to Strike                     | Motions to Strike: May 21, 2002<br>Replies to Motions: May 23, 2002 |
| Evidentiary Hearings                  | May 29 – June 5, 2002   |
| Briefs re: Phase 2 Issues             | Opening Briefs: June 14, 2002<br>Reply Briefs: June 21, 2002        |
| Draft Decision re: Phase 2A           | July 2002   |

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<sup>1</sup> Bifurcating Phase 2 has the added advantage of providing parties with the benefits of a Commission decision sooner about the largest financial issues raised by the audit report as they prepare for and litigate Phase 3.

| <b>Phase 2B Schedule</b>              |   |
|---------------------------------------|---|
| <b>Event</b>                          | <b>Date</b>   |
| Written Testimony for Phase 2B Issues | Opening Testimony: June 28, 2002<br>Reply Testimony: July 19, 2002    |
| Motions to Strike                     | Motions to Strike: July 24, 2002<br>Replies to Motions: July 26, 2002 |
| Evidentiary Hearings                  | July 31 –August 13, 2002  |
| Briefs re: Phase 2 Issues             | Opening Briefs: August 28, 2002<br>Reply Briefs: September 4, 2002    |
| Draft Decision re: Phase 2            | October 2002  |

In order to achieve the revised schedule for Phase 2A, it will not be possible to hold an additional prehearing conference.<sup>2</sup> In addition, the decision for Phase 1 might have to be consolidated with the decision for Phase 2A.

As set forth in the assigned Commissioner's ruling issued on December 27, 2001 (ACR), the parties that plan to participate in hearings for Phase 2A and/or Phase 2B shall meet and confer prior to start of evidentiary hearings for each Phase for the purpose of preparing a Joint Hearing Schedule & Exhibit List that contains the following information<sup>3</sup>:

1. Proposed witness schedule.

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<sup>2</sup> This ruling reserves judgment on whether a prehearing conference is necessary for Phase 2B.

<sup>3</sup> Assigned Commissioner's Ruling Determining the Category, Scope, Schedule, Need for Hearing, and the Principal Hearing Officer for the Proceeding, dated Dec. 27, 2001, p. 10.

2. Cross-examination time estimates.
3. Witness constraints, if any.
4. Title, subject matter, and number of each exhibit, the identity of the offering party, and the sponsoring witness.

The joint exhibit shall be filed at least five business days prior to the start of evidentiary hearings for each Phase. The hearings will be conducted in accordance with the Joint Hearing Schedule & Exhibit List submitted for each Phase unless the assigned Commissioner or assigned ALJ specify otherwise. In addition, parties should adhere to the instructions for handling hearing exhibits contained in Appendix B of the ACR.

Any party that plans to participate in the hearings without presenting written testimony (e.g., cross examination of witnesses) should file and serve notice of such participation at least 10 business days prior to the start of hearings. There is no need for parties to attend the hearings in order to be placed on the service list for this proceeding. The order instituting this proceeding provides instructions on how to be placed on the service list without attending a hearing.

**IT IS RULED** that:

1. The schedule for Phase 2 of this proceeding is revised as set forth in the body of this ruling.
2. Parties shall follow the instructions regarding the evidentiary hearing that are set forth in the body of this ruling.

Dated April 24, 2002, at San Francisco, California.

/s/ LORETTA M. LYNCH  
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Loretta M. Lynch  
Assigned Commissioner

**CERTIFICATE OF SERVICE**

I certify that I have by mail, and by electronic mail, to the parties to which an electronic mail address has been provided, this day served a true copy of the original attached Assigned Commissioner's Ruling Revising the Schedule for Phase 2 on all parties of record in this proceeding or their attorneys of record.

Dated April 24, 2002, at San Francisco, California.

/s/ KE HUANG

Ke Huang

**N O T I C E**

Parties should notify the Process Office, Public Utilities Commission, 505 Van Ness Avenue, Room 2000, San Francisco, CA 94102, of any change of address to ensure that they continue to receive documents. You must indicate the proceeding number on the service list on which your name appears.

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The Commission's policy is to schedule hearings (meetings, workshops, etc.) in locations that are accessible to people with disabilities. To verify that a particular location is accessible, call: Calendar Clerk (415) 703-1203.

If specialized accommodations for the disabled are needed, e.g., sign language interpreters, those making the arrangements must call the Public Advisor at (415) 703-2074, TTY 1-866-836-7825 or (415) 703-5282 at least three working days in advance of the event.